

Financial Sector Review and Strategy

Options

TASK 5 REPORT



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VIII. LIST OF ACRONYMS

Accelerated Microenterprise Assistance Project	AMAP
Central Eastern Europe	CEE
Center for Development Information and Evaluation	CDIE
Consulting Assistance to Economic Reform	CAER
East West Management Institute	EWMI
Economic Growth Agriculture and Trade	EGAT
Europe and Eurasia	E&E
Federal Deposit Insurance Corporation	FDIC
Financial Sector Development	FSD
Financial Sector Development Program	FSDP
Financial Sector and Privatization	FSP
Financial Sector Volunteer Corp	FSVC
Freedom Support Act	FSA
General, Business, Trade and Investment	GBTI
Indefinite Quantity Contract	IQC
Institutional Reform and the Informal Sector	IRIS
Legal and Institutional Reform	LIR
Office of Economic Analysis	EA
Office of Emerging Markets	EGAT/EM
Microfinance Institution	MFI
Non-Bank Financial Institution	NBFI
Partners For Financial Stability	PFS
Policy Coordination Bureau	PPC
Private Enterprise Development Support	PEDS
Professional Service Contractor	PSC
Scope of Work	SOW
Security and Exchange Commission	SEC
Small and Medium Enterprise	SME
Support for Economic Growth and Institutional Reform - Finance Sector	SEGIR FS
Support for Eastern European Democracy Act	SEED
Technical Assistance	TA
Temporary Duty Assignments	TDY

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I. PROJECT SUMMARY

This summary serves three purposes. First, it provides an overview of the Financial Sector Review and Strategy Project that Deloitte Touche Tohmatsu undertook for USAID's Office of Economic Growth (EGAT/EG) - so that the reader can understand the project's structure and progress without having to read the previous three papers in this series. Second, it outlines our findings and conclusions as they relate to the objectives of the project; and third, it presents a list of options and our recommendations as to potential future directions for USAID's financial sector development activities and the role that EGAT/EG can play in supporting these activities, thus summarizing the remainder of this paper.

1.A. THE FINANCIAL SECTOR REVIEW AND STRATEGY PROJECT

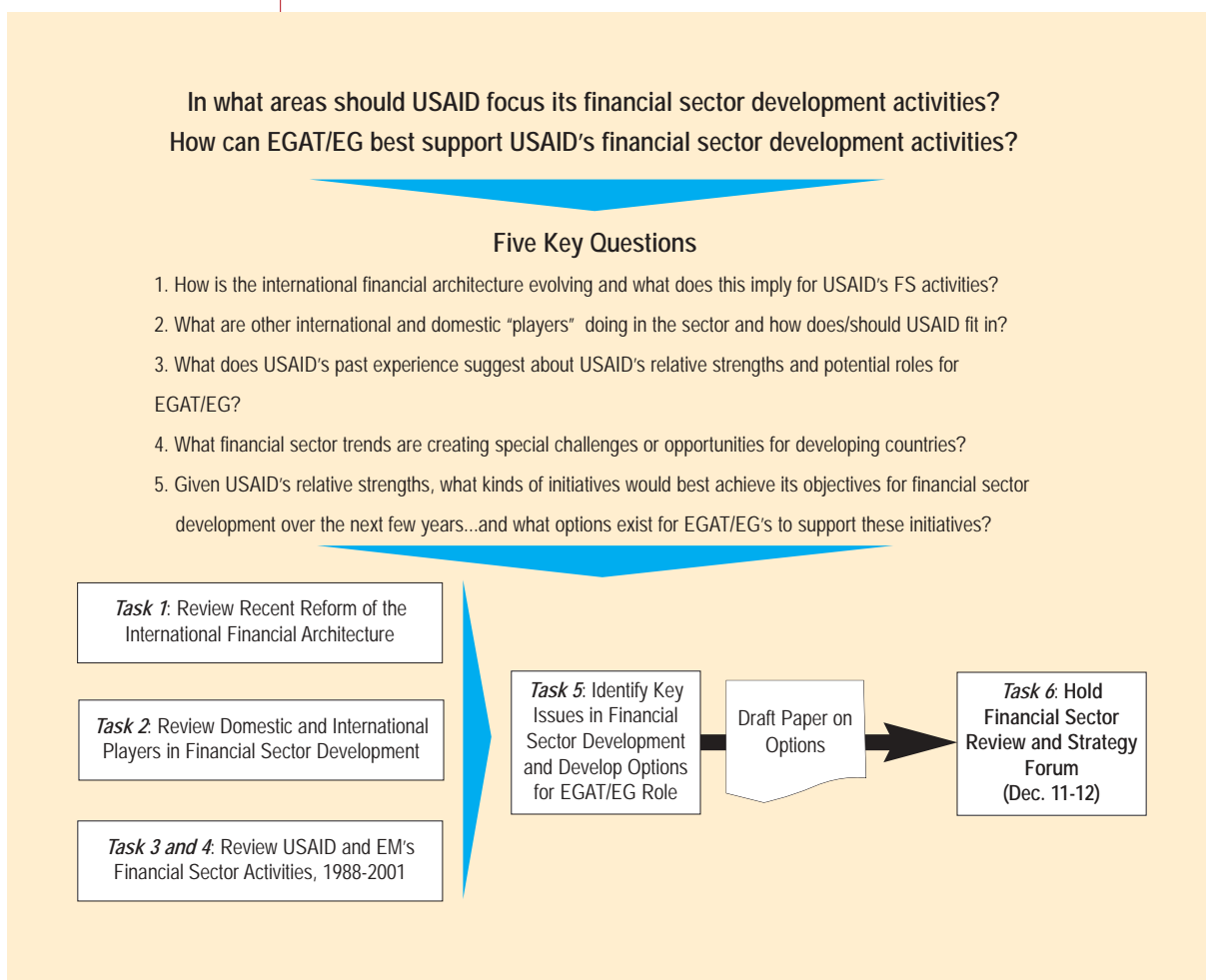
In September 2001, the Office of Economic Growth (then known as the Office of Emerging Markets) commissioned Deloitte Touche Tohmatsu (Deloitte) to conduct a study of trends in international financial sector development and a review of USAID's work in this area from 1988 to 2001. The objective of the study was to develop a list of alternative ways in which EGAT/EG could enhance its role in supporting USAID's financial sector development initiatives over the next ten years. It soon became apparent that addressing this objective would involve a broader look at the potential future of USAID's work in the financial sector.

These questions must be addressed in the context of a series of new challenges that will affect USAID's financial sector programs. First, the Agency's human and financial resources are being redirected to reflect the Bush Administration's priorities. Second, new mechanisms for funding development assistance, such as the Global Development Alliance, are starting to be incorporated into Mission interventions¹. Third, funding for the Central and Eastern Europe region, which has received the bulk of USAID's financial sector funds in recent years, is being scaled back. Fourth, USAID has undergone a substantial reorganization that resulted in the formation of the Economic Growth, Agriculture and Trade (EGAT) Bureau, which has been tasked with providing field support and technical leadership in all economic growth areas to USAID programs worldwide - including financial sector development. Finally, the international financial architecture is undergoing substantial changes that will have broad-

¹ *The Deloitte team did not undertake a review of the Global Development Alliance. However, there does seem to be an appropriate role for a partnership with the US financial services community in a financial sector strategy. Already GDA is involved in a project with international accounting bodies to introduce professional certification in USAID partner countries. Wall Street professionals are working with USAID on corporate governance issues through GDA. Moreover, USAID collaboration in the US Treasury's Financial Sector-led Growth Initiative may provide other avenues to increase market access for US financial services firms in developing countries.*

reaching effects on the development of many USAID recipient nations. These new challenges necessitated a review of USAID's financial sector activities and the role that EGAT/EG should play in supporting them.

Accordingly, the project was structured around five key questions, the answers to which would allow us to address the project objectives in an informed and fact-based manner. The key questions were translated into specific tasks, as seen in the graphic below which illustrates how the project was structured:



This paper represents the culmination of the project team's work and is intended to serve as a starting point for discussions in the Financial Sector Review and Strategy Forum to be held at USAID on December 11-12th, 2002. While the paper itself is concerned with Task 5 above, this summary provides highlights of the findings of the previous four tasks as they relate to Task 5.

Before moving into a summary of the team's findings, it is important to clarify the scope of the project and note its boundaries. The Financial Sector Review

and Strategy Project is, by design, neither exhaustive nor definitive. The project was never intended to be a comprehensive survey of global trends in the financial services sector, nor was it intended to be the final word in setting USAID's financial sector strategy for the next decade. Rather, the project suggests a range of alternatives that EGAT/EG and its counterparts within USAID can use to set assistance priorities and determine the optimal role for EGAT/EG to play in supporting USAID's financial sector development assistance - this paper serves only to start a discussion. The breadth and depth of our analysis was constrained by both time and data availability. The project, for example, addresses only technical assistance (TA) activities and not other forms of financial assistance like enterprise funds or on-lending programs. Moreover, no responsible analysis can ever be better than the data on which it is based. In reviewing USAID's financial sector work over the past fourteen years, the team was constrained by information that was not directly comparable across projects, unconfirmed, or simply not available. In some cases, the information that was missing was more telling than the information that was available - as the following pages will explain.

TASK 1: Reform of the International Financial Architecture

Findings: Most of the general reforms to the international financial architecture (IFA) are well known - work towards greater transparency and promotion of financial market stability, for example. The key issues are already being addressed at senior levels of government and international organizations, so it is unlikely that USAID would have much opportunity to influence the general direction of the reform process at this level. Nevertheless, there are clear opportunities for USAID to support and influence the reform process on a more practical level, by working in the context of the IMF and World Bank's Financial Sector Assessment Programs (FSAP) initiative. FSAP components include Reviews of Standards and Codes (ROSCs), evaluations of domestic financial systems' vulnerability to shocks (Financial Sector Stability Assessments - FSSAs), and identification of the main development needs of a country's financial system and the required follow-up measures (Financial Sector Assessments - FSAs). In 2000 and 2001 alone, the Bank and the IMF conducted FSAPs in some 35 countries and this effort has caused them to direct much of their technical assistance resources to surveillance activities.

Implications for USAID/EGAT/EG: The FSAP initiative impacts bilateral donors in three key ways. First, FSAPs have increased the demand for technical assistance. Developing countries with potentially deficient supervisory systems are requesting pre-assessment assistance in order to improve their FSAP results. Other countries that discover unanticipated deficiencies in the course of an FSAP are requesting help in correcting the deficiencies. Second, since FSAPs identify specific development needs, they make it easier for bilateral

donors to target their technical assistance activities. Third, FSAPs might provide a ready-made impact assessment tool - bilateral donors can evaluate the success of their initiatives in terms of the recipient country's tangible improvements against FSAP criteria.

Following are specific suggestions for USAID/EGAT/EG to consider based on Task 1 findings:

1. USAID can use the FSAPs as a point of departure for designing its own TA initiatives in some cases. EGAT/EG might disseminate FSAP reports and work with Missions to design projects- perhaps by developing sample Terms of Reference.
2. USAID might also use the available FSAP results as a part of assessing the impact of its own projects. EGAT/EG might provide a focal point for standardizing this assessment methodology and applying it across relevant Missions.
3. FSAP-oriented TA activities might lend themselves particularly well to public-private partnerships. For example, twinning arrangements with US banks might be established to help a developing country's banks learn how to comply with higher regulatory standards. EGAT/EG could support Missions by helping to facilitate these partnerships.

TASK 2: Domestic and International Players in FS Development

Findings: Deloitte's Task 2 report discussed the recent activities of key players in financial sector development in some detail, ranging from international forums such as the G7 and the Financial Stability Forum to the regional development banks and the major bilateral donors. Three major findings of this report stand out in terms of their relevance to the future direction of USAID financial sector activity and EGAT/EG's potential role in supporting this activity.

The most salient finding is that there is a dearth of rigorous, objective evaluations of the impact of donor assistance projects. While approaches vary among agencies, few donors can consistently present comprehensive or measurable impact assessments. This suggests an opportunity to improve project selection and design by more systematically collecting and then more rigorously building on the lessons learned through past experience.

Two additional findings relate to USAID's comparative strengths and weaknesses among major donors. First, USAID has a substantial advantage over multilateral donors in that it can fund relatively large TA programs with grant funds, rather than loans, over a longer period. Second, USAID may not be as well equipped as some other donors to design and manage regional programs - this is due to USAID's fairly decentralized structure that places most program-

ming authority within country Missions - while this structure is a drawback in this context, it of course conveys other advantages.

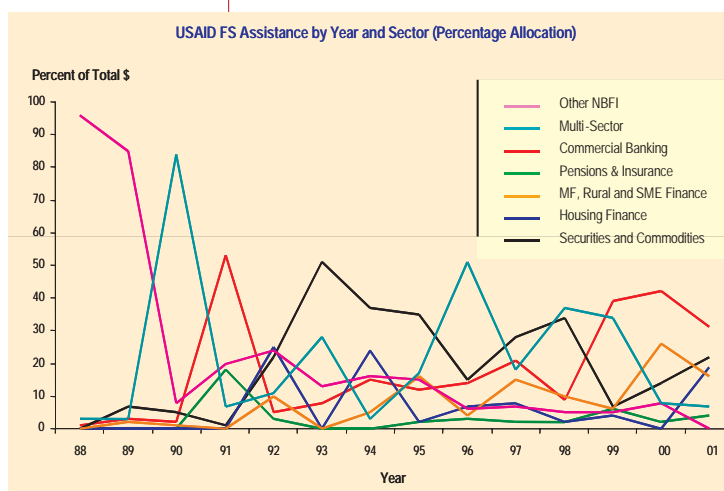
Implications for USAID/EGAT/EG: First, EGAT/EG might support the Missions by developing and maintaining a consistent, objective impact evaluation methodology for financial sector assistance projects - this concept is discussed in more detail in the following pages. Second, USAID should continue to cooperate closely with other donors and take on areas of assistance in which it has a relative advantage. Finally, EGAT/EG can play a strong role in initiating and coordinating regional (cross-national) projects.

TASKS 3 & 4: USAID and EGAT/EG Financial Sector Activities, 1988-2001

Findings: Deloitte undertook an in-depth study of USAID's work in financial sector development over the past fourteen years, relying on the Agency's project files and complementary sources for primary data. During this period, USAID spent just over \$1.2 billion on financial sector development TA through 761 separate projects in 87 countries - well over half of this amount went to countries in the Europe and Eurasia region. As alluded to earlier, however, the information that was missing was more telling than the information that was present - there were very few evaluations of the impact of any of the projects,

and those that did exist were incomplete and the formats and contents were inconsistent with each other. This was the first and most striking finding resulting from this component of the project.

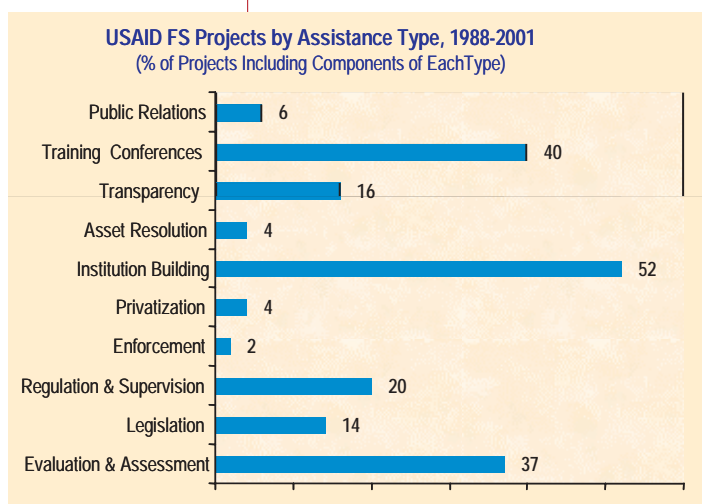
The second key finding was that USAID's financial sector assistance fluctuated fairly widely across sub-sectors during the period of analysis. For example, TA projects in the area of pensions and insurance accounted for 18 percent of total spending in 1991, but fell to



3 percent in 1992 and never rose above 4 percent thereafter. Assistance in the area of securities and commodities made up more than a third of the total in 1998, fell to 7 percent the next year and rose back to nearly a quarter by 2001. Over the same period, aid to the commercial banking subsector rose from 9 percent in 1998 to 39 percent in 1999, but had fallen back to less than a third of the total by 2001. The chart on the following page illustrates USAID's spending patterns across financial subsectors over the past fourteen years.

The high level of fluctuation across subsectors illustrated here could be skewed somewhat by a small number of large projects or, given that projects are largely designed by Missions rather than by a centralized unit, the pattern might represent a responsive approach to changing needs across a large number of countries and a long period of time. However, the wide changes in the allocation of funds could well represent a relatively random or "fashion"-driven approach to funding priorities. In any case, the data suggest that USAID might look more

closely into the criteria and processes used to determine assistance priorities both within and across Missions.



The team also analyzed the available data in terms of the types of assistance provided, using the ten categories shown in the chart below. Three observations stand out: first, only just over a third of projects involved an assessment, so for every project that conducted some sort of initial assessment to determine assistance needs, there were nearly two that did not do so. Second, less than 2 percent of projects

addressed enforcement or surveillance - even of 136 projects that were aimed exclusively at regulatory agencies, only 5 included any work on enforcement. Third, only 6 percent of projects included a public relations component - even including those related to politically sensitive issues such as pension reform. On the positive side, more than half of USAID's financial sector development projects addressed institution building and about 40 percent included training.

Implications for USAID/EGAT/EG: The first two findings described above - a lack of impact evaluations and an apparently random fluctuation of assistance across subsectors - together suggest that EGAT/EG might support Missions by designing and helping implement a standard impact evaluation methodology that can be used as an input into the priority-setting process. The relative lack of attention to issues of enforcement suggests an opportunity to focus more on this area as appropriate in each recipient country. Half of all USAID projects over the past fourteen years dealt with legislation, regulation/supervision, and transparency. Assuming that these projects enjoyed at least some success, it stands to reason that a logical next step might involve helping financial sector regulators to monitor and enforce institutions' compliance with new regulations. Finally, the fact that only a very few projects included a public relations component is surprising when one considers three observations. First, many USAID projects potentially affect a large portion of recipient countries' populations - pension reform is one example, but there



are many others. Second, USAID projects promote regulatory and legal reforms that can often be controversial or that can negatively impact powerful

TOP TEN SUGGESTIONS FOR USAID/EGAT/EG

The Executive Summary of Deloitte's Tasks 3 & 4 Report includes a more detailed analysis of USAID's spending patterns in financial sector development (FSD) assistance. Based on this analysis, the Report offers ten specific recommendations for USAID, summarized below. Please refer to the Tasks 3 & 4 Report for more detailed explanations of the recommendations.

1. Confirm or revise the current means of determining FSD spending levels
2. Assess the ways in which Missions prioritize and fund FSD projects
3. Allocate funding and know-how to evaluating project results
4. Continue to support legislation, regulation and supervision for with emphasis on MFIs and other NBFIs, as needed
5. Focus on enforcing existing laws and regulations rather than creating new ones
6. Emphasize the importance of public relations in more projects
7. Craft projects in response to specific country needs, not according to general trends
8. Allocate sufficient financial and human resources to central functions
9. Find opportunities to cooperate with USAID programs in other sectors
10. Strengthen the links between FSD and poverty alleviation.

vested interests - such projects need to create a "pro-reform" constituency if they are to succeed. Third, one of USAID's overarching objectives is to promote US interests - this objective is obviously served by "advertising" the benefits that USAID's assistance programs often deliver to recipient countries. Considered together, these three facts suggest that USAID might consider making public relations a more regular feature of its projects.

TASK 5.1: Key Issues in Financial Sector Development

Findings: EGAT/EG asked Deloitte to identify global trends or issues in financial sector development that might affect the direction of USAID's programs in the near future to supplement the findings of the first four tasks. It is clearly important to understand the issues that USAID's projects

might address in the future in order to determine how EGAT/EG can best support those projects. Before summarizing the key issues and considering how USAID might best respond to them, it is important to note three caveats. First, this list is by no means exhaustive - it includes some key developments that, in our opinion, could be relevant for USAID as it develops its financial sector strategy and determines the optimal role for EGAT/EG. Second, while micro- and SME finance are obviously important, they are not discussed here². Those sectors are often neglected by the formal financial sector and donors have dedicated significant resources to promote SME growth as SMEs are considered to offer great potential for the creation of economic growth. However, because donor projects in these fields are typically more concerned with extending the reach of financial services rather than improving the intrinsic stability or performance of the financial sector and because micro- and SME finance can be a specialized discipline, we have not included it in this paper. Third, and most importantly, this list is not meant to form the basis of a blueprint for USAID's financial sector development activities for the next decade. As mentioned,

² However, it should be noted that during the course of this project, a white paper on Microfinance was presented to EGAT/EG management for their review. Furthermore, comments on micro- and SME finance which could expand the reader's understanding of one contractor's perspectives on these financial subsectors can be found in Appendix 2.

USAID should continue to craft its projects in tailored response to country-specific needs and resist the temptation to follow or anticipate trends. As per EGAT/EG's guidance to us, allocation of funds will of course continue to be driven primarily by local (or in some cases, regional) development needs, with an understanding of global trends in mind.

The five key issues in financial sector reform that are most likely to affect a large number of USAID client countries, with implications for the Agency's funding priorities, are as follows:

1. **Globalization, consolidation and convergence** of markets and intermediaries, which has already had a profound impact on financial sectors in many developing countries. Several countries, for example, are considering establishing single financial sector regulators to better supervise integrated and increasingly complex activities of financial institutions.
2. Improved **information disclosure and governance**, cornerstones of IFA reform, designed to promote greater transparency and accountability - and thus better protection for investors. FSAPs and particularly ROSCs, as mentioned, have proven a useful tool for identifying and prioritizing countries' needs in this area.
3. **Electronic finance**, which is spreading quickly even among developing countries, and affects not only securities trading, but basic banking and a number of other areas. The advent of e-finance could give some developing countries a chance to "leapfrog" their way into the global economy, yet also introduces new risks and challenges for less sophisticated players.
4. **Safety net reforms**, such as pensions, deposit insurance and investor protection. The former will grow in importance in developing countries in Asia and Africa as their populations rapidly age, and the latter two have become critical in the wake of recent crises. These areas all share the key effect of mobilizing savings and protecting the vulnerable.
5. **New financial products and tools**, which have done more to transform the character of financial markets than any other development over the past twenty years. They have created new sources of finance, induced disintermediation and enabled better management of risk. However, they also increase market complexity and the associated challenges of regulation.

Each of these trends presents a range of new policy, institutional, and human resource requirements for financial institutions and regulators in developing countries - and this in turn creates new opportunities for USAID to provide more valuable and targeted assistance to its client countries.

The table on the following pages summarizes some interventions, among many, that USAID field Missions might consider in light of these global financial sector developments mentioned above.

Table 1: Interventions

	TECHNICAL AREA	INDICATIVE DONOR INTERVENTIONS DRIVEN BY TRENDS
Globalization, consolidation and convergence	Crises Mitigation	<ul style="list-style-type: none"> • Development of contingency plans for crises management and mitigation (lender of last resort policy, capital market master planning, bank resolution master planning, etc.) • Mediation and design of cross-border cooperative arrangements for insolvency reform • Insolvency system reform • Develop innovative mechanisms for banks and regulators on the resolution and workout of troubled debt
	Capital Markets	<ul style="list-style-type: none"> • Targeted TA for the implementation of FSAP recommendations • Assistance in meeting EU integration requirements (CEE countries) • Support harmonization of regulatory standards and trading mechanisms - i.e. establish assistance packages that focus on standardized technology packages so that it would be reasonably easy at a later stage of development to move toward global or regional integration • TA for the deepening of financial markets. This may include new product innovations as described below, and/or more traditional product categories, such as government bond markets, that form the bedrock of fixed income markets
	Regulation and Supervision	<ul style="list-style-type: none"> • Support for developing regulatory strategy, policy frameworks, and market-development oriented approaches for banks and non-banks • TA to improve the legal framework and supervisory capacity for consolidated regulation (with the entry into those markets by international financial conglomerates). • Support for the implementation of policies and guidelines on the proposed new Basle guidelines • Support for implementation of risk-based supervision and early warning systems • Support for the design and implementation of integrated supervisory structures that link banks and non-banks • Mediation and design of cross-border and domestic cooperative arrangements that broaden oversight and improve regulatory coordination • Development of intervention and resolution frameworks for distressed institutions • Assistance in developing mechanisms that catalyze interaction between regulators and the institutions they supervise • Support in the development of SROs; assistance in integrating SROs into formal regulatory operations • Legal reform, including strengthening administrative agencies, developing legal standards for judicial review of supervisory decisions, alternative dispute resolution
	Banking and Non-Banking	<ul style="list-style-type: none"> • Support for the development and implementation of risk management systems and procedures in response the proposed new Basle guidelines • Assistance in meeting EU integration requirements (CEE countries) • Support growth in non-bank subsidiaries such as leasing and insurance companies
	WTO Accession/Trade	<ul style="list-style-type: none"> • Build the institutional capacity to supervise and regulate a liberalized financial sector in line with international standards
Information Disclosure and Governance	Accounting, Auditing, and Disclosure	<ul style="list-style-type: none"> • Continue efforts to adopt international accounting and auditing standards by: strengthening the accounting and auditing profession; development of national policies on auditor independence; development of sustainable SROs, assisting enterprises and institutions in converting their accounts to IAS, and harmonizing local accounting standards with global standards • Support for the development of laws and regulations for better disclosure; assist in the establishment of enforcement procedures and evaluative frameworks to ensure compliance with disclosure standards • Support development of credit bureaus
	Market Discipline	<ul style="list-style-type: none"> • Develop mechanisms that increase the role of market discipline in the operation of financial markets • Develop systems and tools that collect, aggregate, and disclose information on intermediaries, enterprises, financial products and markets (e.g. credit rating agencies, shared credit systems, etc.)
	Corporate Governance	<ul style="list-style-type: none"> • Assist countries to build legal framework and institutions to comply with the OECD principles of corporate governance • Increase measures for improved public sector governance, in particular of state-owned banks and asset management companies • Establishment of mechanisms to strengthen shareholder activism and communication of shareholder rights • Support in the design of governance structures for public institutions and agencies

	TECHNICAL AREA	INDICATIVE DONOR INTERVENTIONS DRIVEN BY TRENDS
Electronic Finance	Regulation and Supervision	<ul style="list-style-type: none"> • Assist in establishing new central policies on the regulation, extension of assurance, and payment systems access of e-finance operations • Assist in evaluating the macro impact of new operations and exposure (e.g. on lender of last resort policies, commercial organization, and market structure) • Support revision of the legal framework for protection of consumers and investors • Support for the strategic evaluation of e-finance opportunities • Development of new institutions or mechanisms that leverage e-finance to increase access to financial services in under-served areas
Safety Net Reform	General	Country assessments of safety net extension from the point of view of: suitability, design, efficiency, breadth of coverage, regulation and governance
	Pension reform	<ul style="list-style-type: none"> • Support for the overall development of pillar private pension schemes (policy, regulation, governance, financial management, advocacy and outreach, and capacity building) • Support for the reform and strengthening of state pension operations • Assist in the set-up, organization, function and design of a pension supervisory agency • Develop pension regulations (licensing criteria for pension fund management companies, advertising guidelines, asset segregation and minimum capital/reserve requirements, investment rules, disclosure and reporting requirements) • Assist in upgrading technology for data collection and analysis to support the pension supervisory agency, pension funds and individual pensioners
	Deposit Protection	<ul style="list-style-type: none"> • Assessment of the suitability of depositor protection arrangements. • Support for the best practice design and development of deposit protection schemes • Assistance in the design and implementation of public consultation studies • Development of risk-based pricing approaches • TA for: improving the coordination between regulators and deposit insurance agencies; developing pricing mechanisms, reforming existing systems
	Investor Protection	<ul style="list-style-type: none"> • Assistance in the development and regulation of investor protection funds • Assistance in the strengthening of capital markets regulation for more precise protection of investors
New Financial Products	Derivatives and Securitization	<ul style="list-style-type: none"> • TA for the development and application of new product-market deepening technology; assistance in using this technology to facilitate financial intermediation where structural barriers that stand in the way of normal market development • TA on the public policies and regulation governing new technologies/products • Assistance in the development of risk management policies and procedures for new products • Assistance in the development of risk management policies and procedures for new products • TA for the development of an enabling environment for special purpose vehicles, trusts, and other contractual vehicles - legal structures that facilitate risk-fencing of risk, the separation of ownership interest from beneficial interest, or secure capture of cash flow/collateral for pass thru securities • Market education, outreach and policy assistance on new technologies
	Credit Products	<ul style="list-style-type: none"> • Support for the development of credit products by: product design, training, infrastructure development, rating systems, etc • TA for the development of mortgage markets • TA for the development of corporate bond markets
	SME Finance	<ul style="list-style-type: none"> • Assistance to banks in developing strategies and service offerings under <i>SME banking</i>. (This goes beyond SME finance to include whole business strategies leveraging distribution channels, deposit products, and non-credit services) • Assistance to NBFIs and/or MFIs in providing SME-specific products



TASK 5.2: Potential Roles for the Office of Economic Growth

The majority of USAID's financial sector work will continue to be designed and implemented at the country level, based upon specific country strategies developed by the Missions. However, EGAT/EG has an important role to play in supporting the Missions' work and helping to ensure the ultimate success of their projects. Specifically, EGAT/EG has two objectives with regard to supporting the Agency's financial sector development work:

- 1. Field Support:** At the country level, EGAT/EG should continue to provide information to Missions to assist them in selecting which technical assistance projects to support. When possible, EGAT/EG should assist Missions in project design, through its own resources and by facilitating access to contractor and USG resources through its global mechanisms. EGAT/EG might also consider taking on a more active role in ensuring that projects chosen by Missions and Regional Bureaus are well implemented. As mentioned, designing and rolling out a standardized impact evaluation methodology might best further this objective.
- 2. Technical Leadership in New and Existing Programs:** EGAT/EG should promote excellence in ongoing field programs and should help lead other programs in technical areas that are new for USAID and that address key issues in financial sector development. Activities to support this second objective could include knowledge management, research and staff training, as well as coordination with other donor organizations.

We would suggest that a third area in which EGAT/EG might take on a leadership role would be in the design and management of cross-national (regional) programs. Some financial sector problems cannot be addressed effectively at the country level, or otherwise lend themselves to a regional approach and provide benefits that are not easily identifiable at the country level. In other areas, a regional approach can create important economies of scale. The development of capital markets among the smaller Balkan countries is one example, while harmonizing disclosure or accounting requirements for cross-border transactions is another.

A fourth broad area in which EGAT/EG might enhance its support for Mission-driven financial sector development work is in regard to assisting client countries meet WTO conditions for trade in services. WTO access has increasingly become a prominent part of many USAID country strategies, and leadership in this area from Washington could be as important as leadership from the field. Also, financial markets in some regions are beginning to integrate and regional blocs seem to be developing in the Balkans, Southeast Asia and perhaps also Central Asia. There would appear to be a need for a central USAID unit to initiate and monitor financial sector programs in response to these changes, and EGAT/EG would be well placed to take on this role.



Finally, EGAT/EG might consider initiating global programs that are consistent with its technical leadership mandate. EGAT/EG might work with Missions to implement pilot projects that address country-specific issues related to the key financial sector trends listed earlier. These projects would likely represent new approaches for USAID, would likely require specialized expertise that might not be available within a given Mission, and could require some research and conceptual work to be performed in advance of a project to identify common problems across countries and develop tools to be used in solving them. EGAT/EG is particularly well placed to launch such pilot projects because it can take on greater uncertainty than Missions - assuming its mandate explicitly includes innovation and experimentation with new project designs.

In considering the list of global trends and the possible interventions (See above), we suggest below some illustrative projects which meet the criteria for a global program for EGAT/EG to undertake. Such projects would be meaningful to many USAID partner countries over the next decade:

- **Financial regulation and supervision.** EGAT/EG, by conducting evaluations, might undertake an analysis of USAID's banking supervision projects to date, identifying what has worked and what has not. Using this data and projecting the future needs for regulation and supervision, EGAT/EG could identify those areas which require additional assistance. Based upon this analysis of gaps, EGAT/EG could suggest to Missions the scope and content of second and third generation projects, such as consolidated regulation and supervision, surveillance and enforcement as well as steps countries can take to support the development and reform of the IFA.
- **Compliance with international supervisory standards.** As described above, there is a need for extensive training and internships to upgrade supervisory capacity to meet international standards such as the Basle Core Principles or Basle II requirements, which can be done on a broad scale rather than by individual countries. EGAT/EG could employ implementers to design and deliver this training, sharing the costs of participation with Missions and with beneficiaries.
- **Rating agency/service development.** Under the new Basle capital adequacy framework, there is likely to be a significant increase in the demand for rating services, providing an additional target of opportunity for USAID work. As this is a relatively untested area (although the E&E bureau has done at least one such project in Hungary), EGAT/EG might initiate a pilot effort in specific countries. There may even be scope for GDA involvement, teaming with Standard & Poors, Moody's, Fitch, or other US-based rating services interested in investing in developing countries.

- **Regionalization of securities markets.** We propose EGAT/EG to undertake an initiative to determine how to harmonize or regionalize regulation, supervision, technology, and operations. A technical assistance gap analysis or analysis of the pre-conditions for harmonization could then be used to guide Mission development of statements of work.
- **Prevention of money laundering, terrorist financing, and financial crimes and related law enforcement** are key issues coming to the forefront and most Missions have not integrated these issues into financial sector programs. In parallel with the new World Bank initiative and those of the US Government, in collaboration with interagency partners, EGAT/EG could lead the Agency in tackling these issues on a global or regional basis.
- **Expanding markets through e-finance:** Again, this is an area in which EGAT/EG could take a technical leadership role in analyzing current research on e-finance, identifying potential interventions and then assisting Missions to design programs through which they could assist financial institutions to introduce technologies that lower operating costs and that make it possible to provide financial services more widely.
- **Expanding access to finance for SMEs and for the poor:** USAID has funded several large SME finance activities, the impact of which are still unknown. It is now critical for EGAT/EG to evaluate and synthesize the successes and failures of these SME projects for future project design. Also, USAID's commitment to microfinance indicates a commitment to facilitate access to finance for the poor. Opportunities aside from microfinance to extend finance to the poor through conventional institutions merit further study.
- **New financial instruments development,** which results in better diversification of products and improved financial intermediation, is another innovative area for USAID. Some ongoing projects (India FIRE, Jordan AMIR, others in E&E) have included financial instrument development, but there is little yet understood about the success of these interventions in bringing new products to market. Not only might EGAT/EG commission evaluations to support future project design, but it might also continue training efforts (such as upcoming debt and mortgage market seminars funded by the E&E bureau) across regions.

Aside from undertaking these potential global programs, there are four specific initiatives that EGAT/EG might consider leading in order to enhance its role in supporting USAID's financial sector development activities. These are as follows:

1. **Develop a general country classification system (topology)** to provide direction on types of technical assistance activities. While the FSAP/ROSC process provides useful data, it does not yet cover all USAID client coun-

tries nor does it address every aspect of financial sector development. There is still a need for a system of country classification that would give USAID staff a useful perspective on the position of a given country's financial sector relative to that of other countries - such a system might also prove a useful means of comparing project results across similar countries. One potential system would classify countries according to their vulnerability to financial crises, their commitment to reform, and the size of their financial sector. Classification according to this system would help determine what types of technical assistance would be most relevant and practical for each country. For example, support for non-governmental microfinance institutions in a country that is not particularly committed to reform would likely be more effective than direct assistance to the country's regulatory agency.

2. **Develop rapid responses to financial crises**, in cooperation with other donor organizations and other USG agencies. As a result of the research and conferences EGAT/EG has sponsored as part of its technical leadership, there might be scope for multi-year, multi-disciplinary regional implementation efforts in this area. EGAT/EG could play an important role in conducting research on effective (and non-effective) responses to past crises and possibly by contracting for a financial crisis rapid response team, to complement resources from US Treasury.

Table 2: Potential Roles for EGAT/EG

SCENARIO	LEVEL OF RESOURCES		AREA OF FOCUS
	Staff	Program Funding	
Scenario A: Base case - Mission Support	2	\$500,000	<ul style="list-style-type: none"> • Provide implementation guidance by drafting, negotiating, and managing the three global mechanisms: the SEGIR global contracting vehicles or their successors (SEGIR II); Cooperative Agreements, such as that with FSVC; and Inter-Agency Agreements • Undertake efforts to design country topology
Scenario B: Better Mission Support through Assessments and Evaluations	2	\$2 million	<i>In addition to "A"</i> <ul style="list-style-type: none"> • Commission evaluations to be undertaken by CDIE and/or a contractor with the goal of developing material on lessons learned in those areas of USAID involvement • Analyze lessons learned in financial development and incorporating such practices into project designs
Scenario C: Improved Technical Leadership Through Increased Technical Staff	4	\$2 million	<i>Differs from "B" in that there are more technical staff to:</i> <ul style="list-style-type: none"> • Conduct or participate in assessments and project design in response to Mission requests • Partially overcome constraint of CTO limitations to draft statements of work and actively negotiate and manage global projects. Accordingly, there will be scope for more active projects such as pilot programs
Scenario D: Center for Financial Sector Reform	6	\$5 million	<i>In addition to "C"</i> <ul style="list-style-type: none"> • Dedicate resources to coordinate with other donors and FSAP program in order to assist missions in programming financial sector interventions consistent with international financial architecture • Undertake multi-year regional or global activities • Increase research capacity



3. Design, pilot and roll-out a standardized impact assessment methodology to evaluate USAID Missions' financial sector development projects. As mentioned, the lack of rigorous or objective project evaluations was one of the more striking findings of our project. It is obviously difficult for any organization to learn from its own experience if the results of that experience are not objectively measured and catalogued. Certainly, systematic evaluation of project results can help USAID improve project selection and design going forward, but it can also help in selecting contractors by providing an objective means of evaluating their past work. Finally, systematic project evaluation can help USAID demonstrate tangible impact - and thus secure continued support from US policymakers.

Of course, the degree to which EGAT/EG is actually able to support global programs or launch initiatives such as the ones described above depends on the level of resources that USAID management expects to dedicate to the office. Depending on this variable, the team has assembled four indicative scenarios describing potential roles for EGAT/EG. The scenarios are cumulative - that is, Scenario B encompasses the activities under Scenario A and so forth. The table on the previous page summarizes the four scenarios. Again, these are meant as discussion-starters rather than as a definitive blueprint for EGAT/EG.

As mentioned earlier, this Executive Summary sought to provide a brief review of the Financial Sector Review and Strategy Project that will culminate in the Forum on December 11th and 12th. This summary, like the project itself, is neither exhaustive nor definitive, but rather was intended to identify key trends in financial sector development and lessons learned from past experience that can inform USAID's future activities in financial sector development, and to identify realistic options as to how EGAT/EG can best support USAID's FSD activities.

The remainder of this report describes the results of Task 5 in greater detail and is organized into three chapters: 1) an introductory section that lays out the rationale for financial sector reform in the context of USAID's broader objectives, 2) a detailed discussion of the five global developments in financial services that were summarized earlier, and 3) a more in-depth discussion of alternative ways in which EGAT/EG can enhance its support for USAID's financial sector development work.